The banks' role in financing industry

Speech by the Governor[1]

The Governor touches on the increased role of the banks in financing industry, the risks to which this exposes banks in recessionary conditions, and the role of the Bank of England in cases where many banks are involved:

- *The Bank is not involved as a lender.*
- *Each bank must make its own decisions on questions of liability, but there are occasions when joint discussions become necessary.*
- *In such cases the Bank of England is able to play a modest part as a neutral chairman in helping to find a mutually acceptable solution.*

What I would like to do tonight, if you will permit me, is to offer a number of comments, as observed from my position, on your role as bankers in the present economic climate.

Our economic difficulties are clearly of two main sorts. We are in the midst of bringing down the pace of inflation. This requires a tight monetary policy. That battle is well engaged and inflation is falling back—but we must not desist until the battle is won. At the same time, the economy is in a state of recession, rather more severe I think than in other industrial countries; and more severe in Scotland than in many other parts of the United Kingdom.

Both inflation and recession create problems for your customers, and therefore for yourselves. The fortunes of the banks and industry are now, more than ever, closely interlocked; for companies have come to rely almost entirely on the banks to meet their needs for outside finance.

In the 1960s, the banks provided around half such finance, while capital issues raised a substantial part of the rest. In the 1970s while companies have depended to a very much larger extent on the banks, issues of debentures and preference shares, in particular, have shrunk to insignificance.

It is easy to find reasons to account for this shift. Fixed-interest borrowing in the capital market has been discouraged by rapid inflation—and by the rate of inflation being variable and unpredictable. Another factor has no doubt been the weight of public sector borrowing in the gilt-edged market. In these circumstances, borrowing from the banks at short or medium-term at variable rates has seemed less risky to company treasurers than an obligation to pay a high fixed-interest rate for years ahead: in degree the banks have thus in effect become an alternative capital market.

The growing importance of the banks must, however, also owe much to their own energy and enterprise. Apart from their striking role in financing the recovery of oil from the North Sea, which is an area in which your own institutions have been especially prominent, much business elsewhere in the economy has been undertaken in the same spirit—for example in the very rapid development by banks of their leasing business.

Looking at this process from your point of view as bankers, it has had the consequence that lending to companies has come to bulk larger in banks' balance sheets. Over the last twenty years, such lending in sterling terms has grown about half as fast again as the banks' sterling assets in total, while holdings of marketable government debt have been falling as a proportion. The Scottish clearing banks have experienced broadly the same changes in their balance sheet structure as banks elsewhere in the United Kingdom.

These compositional changes carry certain implications. For example, the risks—both to companies, and to banks as creditors—of having large amounts of debt outstanding are magnified in a recession. I do not need to elaborate on the difficulties that companies are faced with. Capital utilisation is low; and profits expressed as a real return on companies' assets have clearly declined to a very low level. We all know instances, and many of you may be involved in cases, of redundancies, plant closures or even insolvencies.

Nevertheless, companies have taken energetic steps to maintain their positions. Stocks have been cut back. Redundancies, though painful, have been resolutely declared and in many areas new manning levels give promise of much improved efficiency. Wage settlements are taking place at a lower level. Some new investment has been pruned—I hope, in the main, only deferred because new investment is essential for the good health of industry in the future. From the figures we have so far for 1980—those for

(1) Speech delivered at the Institute of Bankers in Scotland in Edinburgh on 19 January 1981.

the third quarter are published today—it appears that, thanks to policies of retrenchment, companies have managed, despite lower profits, to prevent their aggregate financial deficit from getting worse. Their bank borrowing has in part served to build up financial assets or to repay other debt. The burden of interest payments has grown; but capital gearing has remained, at least up to the middle of 1980, well below the peak of 1974.

These comments are intended to put the problems in perspective, not to dismiss them. Certainly we at the Bank have seen enough, in some individual cases, of the problems which companies and their bankers face not to minimise the difficulties.

The role that the Bank of England has played in this connexion is sometimes misunderstood. We have in a number of cases been able to perform a useful service in bringing the interested parties together. But I should emphasise two points. First, we at the Bank are not ourselves involved as lenders. Second, how far the banks concerned in any particular case can properly continue to lend has, of course, to remain a matter for the banks themselves to judge. As leading creditors they have a responsibility, both to the companies in debt to them and to themselves, to seek to distinguish between viable companies in temporary difficulty and those in deeper trouble. As you will yourselves be well aware, the banks have been playing a constructive role in seeing industry through its difficulties. But although each bank must reach its own decisions on these questions of viability, there are occasions, especially where a company deals with several banks, when joint discussions become necessary; and in these cases the Bank of England is sometimes able to play a modest but useful part as a neutral chairman in helping to find a mutually acceptable solution.

The Bank of England's role has been criticised, both on the ground that monetary control is being eroded, and on the ground that basically unviable companies are being kept alive, thus impeding needed adjustment. Both criticisms are in my view misconceived. The scale of lending in these cases is scarcely significant in relation to total bank lending or the size of monetary aggregates; in any event, lending by the banks to companies in difficulty would not suddenly fall if there were more insolvencies.

There are situations where some companies will inevitably contract or founder. It is then important that, if good businesses can be retained from within such companies, the banks should—not least in their own interests—do what they can to achieve that result. This will often require time and mutual confidence among those concerned; and if the Bank of England can help in promoting this, then it will surely be ready to do so. One thing that our modest involvement in such situations has shown clearly is the importance of close monitoring by the banks of the condition of their corporate clients, so that timely action can be taken before any deterioration becomes too great.

The theme of my remarks has been the importance of the role the banks now have in providing the external finance for their business clients. In conditions of difficulty that role calls for patience, skill and judgment of a high order; but these conditions can also foster close, knowledgeable and sensitive relationships between banks and industry.